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SUBJECT: KAZAKHSTAN: OIL PRODUCTION PLANS AT THE SUPERGIANT FIELDS OF TENGIZ AND KASHAGAN

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¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: The DCM and Energy Officer visited Atyrau, toured the Tengiz oil field, and met with senior government officials and energy executives in November. Previous reports about the visit (ref A and B) have discussed the corporate culture, political players, educational programs, and investment climate of Atyrau oblast. This report focuses on the plans, prospects, and problems at Tengiz and Kashagan, as the two largest oil fields in Kazakhstan prepare to increase production dramatically in the years ahead. END SUMMARY.

A TOUR OF TENGIZ

¶3. (SBU) Tom Hanson, Maintenance Superintendent for Tengizchevroil (TCO), gave the DCM a guided tour of the Tengiz field on November 6 (ref B). The Tengiz project-license area is immense, and even photographs of its vast, limitless expanse, stretching to the Caspian Sea, do not do it justice. The Tengiz reservoir is 19 kilometers wide by 21 kilometers long, and the oil column measures an incredible one-mile thick. The reservoir area is so large that one would have to run nearly two marathons to cover the entire distance around it. The project area includes the super giant Tengiz field, the smaller but sizable Korolev field, and several exploratory prospects. According to TCO, the Tengiz and Korolev fields contain an estimated 750 million to 1.1 billion metric tons (6 billion to 9 billion barrels) of recoverable oil.

¶4. (SBU) Hanson described the process to separate, stabilize, and load oil into more than 22,000 rail cars and pipelines, such as the Caspian Pipeline Consortium (CPC) pipeline. According to Hanson, dealing with the gas is the hard part. He explained that some of the sour gas is re-injected back into the well to maintain pressure

in the reservoir, and some is treated and separated into liquid-petroleum gas, such as propane and butane, sulfur, and dry gas. Hanson said that Tengiz currently has the highest-pressure gas reinjected in the world, at 650 bar.

TCO'S FUTURE GROWTH PROJECT

¶5. (SBU) Hanson said that the Future Growth Project is not yet sanctioned, but he expects the project to receive approval from the authority (KazMunaiGas) this year and to begin engineering work in
¶2010. TCO General Director Todd Levy told Energy Officer on November 9 that the government is "dragging its feet" on the Future Growth Project and is reluctant to defer short-term revenue from current production. According to an internal TCO presentation that Levy delivered to Minister of Energy and Mineral Resources Sauat Mynbayev, the Future Growth Project will cost $9.7 billion, mainly for new crude stabilizers gas compressors, and power stations. If the TCO consortium and the approving authority -- represented by national oil company KazMunaiGas (KMG) -- sanction the project, it would start in 2017, increase proven reserves by 100-130 million tons, and increase production to 36 million tons per year (or more than 1 million barrels per day, or bpd). Levy said that the reserves and future production growth could be lost forever if the project is not sanctioned in 2010.

GAZPROM SHUTS DOWN TCO

¶6. (SBU) As previously reported, Russia's Gazprom suddenly stopped receiving natural gas shipments from TCO in September (ref C). TCO was consequently forced to reduce oil production at Tengiz and flare more natural gas than anticipated. (NOTE: Levy said TCO was fined $20 million for unauthorized gas flaring caused by Gazprom's refusal to accept TCO gas. Although TCO was within its annual environmental

permit, the company was fined because it did not notify the authorities in advance that it planned to flare that amount of gas in such a short period of time. END NOTE). After Mynbayev raised the issue with Gazprom CEO Alexei Miller on September 11, gas shipments were resumed temporarily. Levy told Energy Officer that Gazprom agreed on November 6 to receive all of TCO's natural gas exports (5 billion cubic meters, or bcm) through the end of 2009. TCO is negotiating with Gazprom to export 6.5 bcm in 2010, which Levy said Gazprom will export to Ukraine. "We practically give the gas away," Levy said, noting that TCO sells to Gazprom at $50 per cubic meter. "We have to move the gas in order to keep the oil flowing."

¶7. (SBU) TCO's Hanson was previously assigned to Karachaganak Petroleum Operating Company (KPO), Kazakhstan's largest gas producer. He told Energy Officer on November 6 that KPO did not have the same problem with Gazprom as TCO, since KPO sells untreated, sour gas to Gazprom for processing, whereas TCO sells sweet, dry gas ready for commercial sale and export to Ukraine.

THE COMPLEXITY OF KASHAGAN

¶8. (SBU) Richard Fritz, public relations director of Agip KCO, formerly the lead operator at Kashagan and now an agent of the North Caspian Operating Company (NCOC), admitted that the Kashagan project now has "a very complex operating model." He explained to the DCM on November 7 that NCOC defines overall strategy, ensures planning and coordination, and is the main point of contact with the government. Agip KCO is responsible for producing 450,000 bpd under Phase I, while Shell Development Kazakhstan, a joint venture of Shell and KMG, is responsible for production operations under Phase II of the project. ExxonMobil has responsibility for drilling under Phase II. Fritz said he is confident that the Kashagan project will be able to combine the policies, cultures, and practices of seven international oil companies into one integrated operation.

AGIP EXPECTS TO MEET FIRST OIL DEADLINE

¶9. (SBU) Fritz reported that Agip KCO has drilled 19 appraisal wells, all of which were successful. He told the DCM that Agip KCO has committed to deliver first oil by December 1, 2012, but he

quickly noted that Agip KCO has made no volume commitment on early oil, and it will "certainly not" produce 450,000 barrels per day (bpd) right away. Fritz noted that Phase I is the only approved portion of the project, and said that Shell production staff are already embedded in Agip KCO to ensure a seamless transition to Phase II. Fritz asserted that Agip KCO could produce 370,000 bpd with existing facilities although he admitted that the company would need additional reinjection assets from Phase II in order to reach its target of 450,000 bpd -- "We have drilled all the wells and have all the modules we need in order to achieve commercial production."

SHELL READY TO RUN PHASE II

¶10. (SBU) Hans Bakker is the Managing Director of the North Caspian Production Operations Company (NCPOC), not to be confused with NCOC. KMG and Shell Exploration and Production created the NCPOC joint venture to manage the production of Kashagan oil during Phase II of the project. Bakker explained that the project was reorganized, and the new, cumbersome corporate structure devised in October 2008 due to "massive government discontent" with repeated delays and rising costs. Agip, he said, "were just plodding along, and the cost just kept getting higher and higher. Finally, it became too much for one company to deal with." Bakker highlighted the total estimated cost of the project now exceeds $150 billion, and admitted that the rising price tag worries the project partners.

DIFFICULTY DEVELOPING LOCAL CAPACITY

¶11. (SBU) Bakker expects NCPOC to grow rapidly, from approximately 200 employees today to 2,500 by 2014. When asked if Kazakhstan

would have enough skilled specialists to meet rising demand, he admitted that this was an "enormous concern." He mentioned NCPOC's receipt of 5,000 applications for just 100 entry-level positions this year, and reported that the company is under "enormous pressure" to meet local content requirements. He also said that, due to project delays, local employees who have already completed Agip KCO's four-year training program (ref B) have not been able to apply their skills and may need to be reassessed or reassigned. "Another option would be to send trainees abroad to hone their skills," he explained, "but that carries additional risks and costs."

THE COST OF DELAYS

¶12. (SBU) Another consequence of repeated delays on Kashagan is the deleterious effect on the project's already-procured, expensive equipment. During lunch with international oil-service companies on November 10, it was alleged that the Kashagan consortium has drilling, power, and other equipment worth more than $100 million "just sitting in warehouses in Atyrau, degrading." They said the blades on generators have not been rotated, and consequently may not function properly, and they pointed out that the warranty on much of the equipment has already expired before it has even been used. "They are going to have to buy and bring in brand new equipment," one company official said. "It's like they're starting over."

KMG'S TRIPLE PLAY

¶13. (SBU) According to Bakker, KMG has little independence and great difficulty in balancing its tripartite role as government regulator, approving authority, and equity partner. "All of these roles become intermingled," he explained, "and anyway, KMG ultimately takes orders from the same people at the very top." For example, Bakker described a negotiation over a real estate contract during which the international oil companies outvoted their equity partner KMG, but the approving authority, also KMG, refused to sanction the deal, giving the national oil company a de-facto veto over project management decisions. "People seconded to Kashagan from KMG represent the government," he said, "not the project. Their first loyalty is to the government."

FINANCIAL POLICE "IMMENSELY POWERFUL"

¶14. (SBU) Bakker pointed out that the government is not a single,

unitary entity. "There is an unusual level of disconnectedness across the government," he suggested. Echoing comments from oil-service companies, he said the financial police report directly to President Nazarbayev, and are "immensely powerful" and "totally out of control" (ref A). For example, Bakker said the Kashagan partners signed an agreement with Prime Minister Masimov in October 2008 that guaranteed tax stability for the project. However, according to Bakker, the financial police asserted the document was not a legal agreement, threatened to press criminal charges against individuals in Agip KCO's tax department, and said, "We don't work for the Prime Minister anyway. Unless the President tells us to back off, we are on this case." They then demanded that Agip KCO deliver 40,000 pages of documents -- translated into Kazakh -- within seven days, or they would move forward with a criminal case. "This sort of thing can put a stop to your business," Bakker said.

¶15. (SBU) COMMENT: Kazakhstan is poised to become one of the world's top ten oil producers by 2015, and is one of only three non-OPEC countries with spare production capacity greater than 1.5 million barrels per day (Canada and Brazil are the other two). Both the international oil companies and the government of Kazakhstan have a lot riding on the ability of Tengiz and Kashagan to achieve maximum production. This visit to Atyrau made clear that a number of practical issues -- organizational, contractual, and financial -- must be resolved in order for those fields to reach their full potential. END COMMENT.

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